Discussion Guide to the Macroeconomic Scenarios and Questions

The macroeconomic conditions of Parador are similar to those in a number of developing countries prior to the "Peso Crisis" or "Asian Contagion" in the last decade. While a macroeconomic crisis in Parador is not imminent, an external shock could easily push the country into the direction of external default and/or currency devaluation. It should be deduced from the country description that Parador's Government is trying to maintain a fixed exchange rate, either with the US Dollar or with a basket of currency representing its main trading partners.

The questions and scenarios posed are the real challenges faced by many developing countries. There are no right or wrong answers, or easy solutions to these questions. The greatest economic minds are still debating as to the "best" approach to many of these issues, and there are many permutations to the outcomes, successes or failures that pertain to unique country circumstances. They are about difficult choices and balancing acts.

Below we outline some key discussion points that utilize the macroeconomic concepts and tools covered by this session.

1) Devaluation next door could bring pressure on Parador's Government to devalue its currency. Parador's currency has been appreciating in real terms, making its exports less competitive, thereby reducing its ability to earn foreign exchange. The country also has a sizeable short-term foreign debt. The latest development in the region may serve as a "wake-up call" to international investors about their risk exposure in the region. Parador may be viewed as less able to service its foreign debt in the near future by the international financial markets. Parador could also be subject to a "currency attack" as investors begin to sell Parador's currency in anticipation of its devaluation.

The short-term goal of the Government's response to this situation is to maintain currency stability and confidence among investors in the country's ability to service its foreign debt obligations, and to prevent a run on its currency and/or banking system. Restrictions on capital outflow, while an option in the short-term, typically scares away investors and can cause panic. The Government should work with the IMF to review options in establishing a contingent credit line to help meet short-term foreign exchange obligations.

Other steps include accelerating existing reforms in the banking and financial sector, strengthening regulatory oversight, and bringing deficit spending under control. While these measures may not have an immediate impact on Parador's financial system, they usually help to reassure domestic and foreign investors that the Government is committed to a strong macroeconomic foundation for the country's continued growth.

2) Governments are often tempted to raise revenue by increasing import duties, because it is one of the few tax areas where enforcement could be more effective. However, import duties create distortions in the domestic economy and it would be

difficult to raise them significantly given the Parador's intention to join WTO. There are merits and drawbacks to the other options. Personal and corporate income taxes may discourage investment and savings in the private sector, but they are less likely to affect the poor. VAT could raise revenues while encouraging savings at the expense of consumption, but it may disproportionately affect the poor unless basic food items and necessities are exempt. Sales tax surcharges on luxuries typically raise a limited amount of revenue, because luxury goods are more price-elastic, and they also create additional distortions in the economy. In order to improve public finance conditions, strengthening enforcement of tax laws (i.e., more effective tax collection) should be given a high priority.

3) Inflation rate is already hovering near the double-digit level in Parador. Monetizing most of the new debt could easily push inflation to the low or mid-teens, and increase expectations for rising inflation in the future. In addition to the undesirable effects inflation could have on the economy and on Parador's citizens, high inflation rates will put pressure on the country to devalue its currency.

Borrowing from the international financial markets also has a number of implications. Rising levels of debt servicing can be only sustained if Parador can earn sufficient foreign exchange from its exports, increase foreign investment flows, or increase remittances from abroad. The country will be more vulnerable to external shocks that would dampen its exchange earnings, reduce foreign investment inflows, or increase outflows. Over the longer term, only policies that increase Parador's export competitiveness, improve its investment climate, and strengthen its financial systems will help the country earn a stable level of foreign exchange to service its foreign debt. .

4) Income distribution can worsen with growth if growth spurts occur unevenly across sectors and regions. However, a highly-skewed income distribution may dampen a country's ability to achieve long-term economic competitiveness and growth, because of inadequate investment in human capital, i.e., health, education, etc. Countries have adopted a variety of strategies to deal with inequity in the society. Some prefer using public resources to raise incomes of those in the bottom tier of the income distribution. Others may levy highly progressive taxes on the top percentiles. Some countries focus on creating equal opportunities, such as deregulating the economy, strengthening the judicial system, curtailing corruption, etc. Generally, social spending in the areas of health and education, and establishing a minimal social safety net are desirable.

5) Such a drastic drop in coffee prices is a serious shock to Parador's economy. It will immediately diminish Parador's ability to service its foreign debt and may bring about a balance of payments crisis. Its gross international reserves – 3 months of import coverage – will not be sufficient to help the economy weather this shock. Rising interest rates in the U.S. would mean rising cost to service Parador's existing foreign debt, further aggravating a difficult situation.

Options for the government in this situation would be similar to those under scenario 1 – putting into place contingency credit lines, sustaining confidence and minimizing investor panic to prevent a crisis from developing. In order to accelerate diversification of Parador's export and economic base, the Government should accelerate the liberalization process to encourage investment in high value-added activities, and nontraditional export development. Over the medium term, the Government will need to re-evaluate its exchange rate policy and consider a possible devaluation.

6) The new focus of the President-elect will likely improve equity in Parador. However, the long-term well-being of Parador's citizens can only be assured by sustainable economic growth that raises living standards for all. Increased trade and foreign investment have a number of advantages, including higher foreign exchange inflows, diversification of the economic base, technology and knowledge transfer, and forcing domestic industries to become more efficient and competitive. High trade barriers may temporarily protect domestic industries from foreign competition, but will also deny the country the benefits from its comparative advantages. However, globalization may also bring some undesirable impacts on Parador, and the President-elect is prudent to note that the rights of workers, the poor and the environment should not be compromised in the process of globalization. Proper legislation should be in place and enforced to ensure that globalization and economic growth can co-exist with other social goals.